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No. 96-454

IN THE
Supreme Court of the United States
OCTOBER TERM, 1996

ASSOCIATION COMMERCIAL CORPORATION,
Petitioner,

v.

ELRAY RASH AND JEAN RASH,
Respondents.

Petition for a Writ Of Certiorari to the United States Court of Appeals for the Fifth Circuit

BRIEF OF RESPONDENT

JOHN J. DURKAY
Attorney of Record
MEHAFFY & WEBER
Post Office Box 16
Beaumont, Texas 77704
Telephone: 409/835-5011
Telecopier: 409/835-5177

Attorneys for Respondents

Alpha Law Brief Company • Houston, Texas • (713) 270-6628 • Fax (281) 552-0001

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QUESTION PRESENTED

Did the bankruptcy court judge apply the proper standard when he found the value of a truck in a proceeding to determine a secured creditor's allowed secured claim?

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STATEMENT OF THE CASE

This case involves the chapter 13 reorganization of Mr. Elray and Mrs. Jean Rash. Under that chapter, they were required to pay all disposable income to a trustee for distribution, under specific statutory guidelines and a plan they formulated, to their creditors. 11 U.S.C. §1325.

I. The Rash Family Business

Elray Rash is a truck owner-operator. This is the single most common form of business enterprise in the heavy trucking industry. An owner-operator owns his own truck, pays the cost of purchasing and maintaining the truck, pays for the truck's fuel and lubricants, purchases casualty loss and liability insurance on the truck, sees to its proper registry and the various state haul and highway permits it may need, seeks contracts for haul and then actually drives the truck, hoping that the contracts for haul pay for all of the above and make a living above and beyond those costs. Many thousands of Americans make their living this way.

Mr. Rash procures his contracts for haul through Lane Trucking. Lane, like most modern large trucking firms, does not own it own fleet but instead accumulates freight for haul in depots and in turn contacts a fleet of owner-operators with whom it has standing business arrangements to hitch up to its trailer and haul the trailer over the highway to its destination.

Lane is paid a lump payment based on the distance the freight is to be hauled, the nature of the freight, ordinarily non-hazardous, and the negotiated price with the customer. Lane pays Mr. Rash seventy per cent of the payment it would receive to haul the freight. Payment arrangements between trucking firms and their drivers vary

considerably, but virtually always are based on units of performance. Guaranteed payments, whether in the form of wages or salaries, are virtually unheard of.

Mr. Rash heads from his house in Jasper, Texas, Monday morning to the Lane terminal in Houston, Texas. From there he hauls fifty-seven foot tandem trailers of Coca Cola products, brewery products, Clorox, and other merchandise across Texas, Mississippi, and Louisiana.

Two important economic considerations therefore shape Mr. Rash's relationship with Lane. First, he is only paid if he drives. If he drives more, he is paid more. If he can not drive because he is sick or his truck is not operating, he is not paid. Second, he is not paid to return home.

Deadheading is an important economic fact of life for truckers. Good freight companies can help to find return freight. If a trucker can find a return load, his trip stands a much better chance of being economically successful. He needs to plan his finances so he can stand an empty haul home but operating a truck twice as far for half the revenue is a tough business.

Lane is good at arranging subsequent hauls when each is completed, but almost always Mr. Rash will have to deadhead for some part of the trip. If, for example, Mr. Rash hauls Coke to Amarillo, he may then pick up a load of Clorox in Fort Worth to carry it to Midland, where he then travels to El Paso to pick up a Shreveport load. In any case, when his week ends in Houston, he has to deadhead back to Jasper to his home.

Through these hauls, knowing the revenue is set for that trip, the trucker then operates the vehicle as economically as possible in light of fuel cost, maintenance costs, and down time costs.

Mr. Rash drives a 1989 Kenworth T-600A with a 444 Cummins six cylinder as the power plant. This is the heavy weight of over-the-highway trucks. It is painted in Lane colors. His trips are lengthy and in order to save on his travel expenses while on the road, the truck is equipped with a sixty-inch "sleeper", an extension to the cab which contains twin bunks. He can pull into a rest stop and take his DOT mandatory rest periods in his truck without having to spend for a motel. Mr. Rash always stays with his truck.

His trips are regulated by Department of Transportation regulations which require that he maintain a log of times driving as opposed to times idle and distances driven each driving time. He is allowed to drive no more than 10 hours at a time between rest periods of at least 8 hours each. Truckers do not know day from night. They only know driving periods and rest periods. Mr. Rash drives generally fourteen hours per day, Monday through Friday.

Additionally, good maintenance practice for his truck required that he keep a careful maintenance log. On the date of Mr. Rash's valuation hearing his truck had logged 380,000 miles. At present the truck has on it over 929,000 miles. It is nearing the end of its useful life, but Mr. Rash has been able to make the truck last as long or longer than anyone might expect through careful, regular and expensive maintenance, including lubrication and fluid changes, air filters, full and partial overhauls, tires, brakes, suspension, constant cleaning and polishing of the body, and replacement of consumable parts such as batteries, hoses, electric cabling, fluid pumps and so forth. These items are not priced like

automobile items. A single truck tire can cost in excess of $700. All this work Mr. Rash pays for out of his pocket. A standard lubrication and oil change servicing costs $140.00. He performed a major overhaul on his engine in 1995 at a cost to him of $6,000 and a year later he did a major overhaul on the "rear-end" (universal, differential, axle, housing and bearings) at a cost of $2,000.00. All of the funds he set aside in his plan for truck maintenance and then some have been expended on the maintenance of the truck.

Mrs. Rash is employed by the Texas Criminal Justice Department. She is a dental assistant and runs the dental clinic at the Jasper Unit of the Texas Department of Corrections, a prison located in Jasper, Texas. She is paid slightly less than $10,000 per year.

II. The Associates' Collateral: The Kenworth.

This case is about the valuation of collateral in bankruptcy. The collateral in question is a 1989 T-600A Kenworth truck. It is brown. It has a tare (empty) weight of 18,800 pounds (in excess of nine tones) and a loaded gross vehicle authorized weight of 75,000 pounds (about 37 and one half tons). It has twin fuel tanks holding 120 gallons each. It has ten twenty- inch wheels. The truck has fifteen forward gears in its standard, double-clutch truck transmission.

Mr. Rash bought his truck on March 30, 1989 from Janoe Kenworth Trucks, San Antonio for $73,700. He traded in a 1986 Peterbilt truck. When he purchased the truck, Janoe arranged for the purchase to be financed by the Associates Commercial Corp., a business which does extensive financing in the commercial field, including trucks, heavy construction equipment, manufacturing equipment, and

so forth. The principal on March 30, 1989, was $68,415.62. The Court should not assume that this was the amount that the Associates drafted to Janoe; discounts in the purchase of installment paper are now common. At the time of his bankruptcy Mr. Rash had made payments totalling $57,900 and owed a principal of $41,171 on the note.

III. Mr. Rash's Bankruptcy

In 1991, Mr. Rash had a mild stroke. He was not permitted by his doctor to drive for approximately three months. He began to fall behind and exhausted savings trying to keep his truck. During this period of time he approached both the San Antonio Kenworth dealer who sold him the truck and the Associates itself and asked the Associates to refinance his truck through this period. He had too much equity in it to just give it up. The Associates was willing to make minor concessions on the payment schedule but was unwilling to forgive any principal or interest and the three month loss of income by Mr. Rash created too large a hurdle for him to make up under the best of the Associates proposals.

The Associates then threatened repossession.

Mr. Rash reluctantly sought the advice of bankruptcy counsel. Mr. Robert Barron is an experienced chapter 13 bankruptcy practitioner officed in Beaumont, Texas. He filed for Mr. and Mrs. Rash a chapter 13 bankruptcy petition on, March 18, 1992, in the Lufkin Division of the Eastern District of Texas.

The Eastern District of Texas has one chapter 13 bankruptcy trustee, Mr. Michael Gross. In connection with chapter 13 bankruptcies the Court requires the prompt filing of a chapter 13 plan of reorganization. Mr. Rash's original chapter 13 plan is dated March 17, 1992, and he actually filed his original chapter 13 plan of reorganization with his petition. That plan called for a repayment to the Associates of $28,500, the claimed value of the truck at that time, plus interest at 9%. Mr. Rash started all plan payments to Mr. Gross within thirty days of filing his bankruptcy.

Chapter 13 plans of reorganization are of no set duration. However, they may not last more than three years without court approval. Five year plans traditionally arise in the context of the requirement that all priority debt be paid in full (generally taxes) during the course of the plan. Often the full five years is needed to pay the priority debt. In Mr. Rash's case, however, his tax debt was not significant. Instead, he asked to remain in the chapter 13 reorganization for a full five years in order to ensure that his truck be repaid entirely within the plan period. This was an extraordinary commitment on his part and by no means necessary from the perspective of the plans this bankruptcy court traditionally confirms.

In Mr. Rash's chapter 13, as in all chapter 13 filings, Mr. Rash had to report to the court all earnings and all contemplated earnings, Official Schedule J, and pay to the chapter 13 trustee all of those earnings above and beyond a family budget, 11 U.S.C. 1325 (b) (2). The family budget is initially proposed by the debtor, but both the chapter 13 trustee and the office of the United States Trustee scrutinize the budget against the thousands of similar chapter 13 budgets to catch discrepancies in allowable household expenses. The creditors also have an opportunity to view the household budget and the proposed plan and copies of these

are all distributed to the creditors and placed on public view in the bankruptcy clerk's records. The budgets are minimal and do not provide for any expenses above and beyond bare family living expenses. As a part of his budget, Mr. Rash also set aside a $400 per month maintenance and repair allowance for his truck. Mr. Rash, during the course of his chapter 13, actually spent all of that money plus an additional $600 to $700 to repair and maintain his truck. The additional sums were diverted from the household budget, or Mr. Rash worked additional hours to accumulate those funds.

Both the chapter 13 trustee and the United States Trustee also review the proposed plan for compliance with Chapter 13 requirements. When an additional $135 a month was required to fund the secured debt, Mr. Rash dropped a $50 a month charitable contribution amount and a $65 per month entertainment amount among other household expense items to fund the additional sums. Throughout this process, Mr. Rash encountered no adverse criticism from either the chapter 13 trustee or the United States Trustee.

The Associates was not Mr. Rash's only secured creditor. He had also borrowed on his home and a car and pickup. Home mortgages are exempted from the chapter 13 process, and those payments are counted in the family expense budget. He owed $15,390 on his mortgage, $4,250 on a 1988 Dodge pickup and $2,750 on a 1987 Buick. Early on Mr. Rash negotiated with and reached an agreement with the Chrysler Credit Corporation on the pickup and with GMAC on the Buick. Mrs. Rash drives the Buick to the Jasper Unit to work and Mr. Rash drives the pickup when home on the weekends. Those payments were included in the plan and did not thereafter change. Mr. Rash made all those payments successfully and was delivered title to his vehicles.

A chapter 13 debtor's schedules and proposed plan of reorganization will take a position with respect to the amount of principal the debtor contends he owes on the security interest. However, that in essence is only a pleading. The secured creditor can accept the number or reject it. The method for rejecting the number is the filing of a proof of claim. A proof of claim under sec. 502 and Rule 3001 will be deemed allowed unless a party in interest objects to the claim. Debtor's counsel found the Associates claim in his examination of the file before the confirmation hearing. He then took the necessary step to destroy the presumption; he filed an objection under §502 to the proof of claim. The §502 objection is served on opposing counsel, so well prior to the commencement of the chapter 13 confirmation hearing, counsel for the Associates was apprised of the joining of the valuation issue.

No step in the standard pattern of secured creditor litigation and contest was left unturned by the Associates. It filed the traditional motion to lift automatic stay and the equally traditional motion for cash collateral order. In both cases, it contended it was undersecured, that the collateral was not needed for the reorganization, and that it was not being paid adequate protection. The Associates knew that Mr. Rash needed his truck for his reorganization and that he had some time earlier been religiously paying on the Associates account to the chapter 13 bankruptcy trustee. Mr. Rash responded to all of these motions in a timely fashion.

By now Mr. Barron understood that the Associates intended to litigate the value of its collateral. This is somewhat unusual in that Mr. Barron has worked out standard pattern settlements with virtually every secured creditor in the community where he practices. Mr. Barron knew that the matter would involve a fact trial and so he prepared his case by taking the most obvious and logical

step. He asked Mr. Rash to have his truck appraised.

IV. The Truck Appraisal

Although apparently now an intense national debate, the question of how Mr. Rash was to appraise his truck was hardly controversial at the time. Mr. Barron required that he take the truck to a qualified truck appraiser in Beaumont and ask that the appraiser appraise the truck. Mr. Rash drove the Kenworth to Beaumont to one of the larger dealers in Beaumont, Smart's Truck and Trailer. Smart dealt in Macks and Whites primarily but handled other lines.

This pattern is repeated many times daily in the city of Beaumont alone, many thousand times daily across the nation. There are numerous individuals in any community who are qualified to, hold themselves out to, and conduct the business of vehicle appraisal. Often, they are a designated individual in a new vehicle dealership; for example, the manager of the used car division. It is not likely that they will own an independent appraisal business as in the case of real estate appraisers. While appraisals are routinely conducted, no one expects to charge a major fee to do so and no one contemplates that that activity can constitute a livelihood per se. But the process is well understood and fees are charged for it. In our case, Mr. Steven Thibodeaux, the sales manager for Smart's Truck & Trailer, introduced himself to Mr. Rash and said he would appraise the truck.

The process of truck appraisal, to those familiar with real estate appraisal, is a familiar one. Nowhere in the literature on appraisal or in the Uniform Standards of Professional Appraisal Practice is there a recognized distinction between the methods of appraising real property and the methods of appraising personal property.

Mr. Thibodeaux followed that process. First, he agreed on a fee, fifty dollars, with Mr. Rash, who then paid the fee. Then he interviewed Mr. Rash to determine the purpose of the appraisal. Mr. Rash explained to Mr. Thibodeaux the chapter 13 process and how Mr. Thibodeaux's number would be used in the process. He further told Mr. Thibodeaux that he might be called upon to testify in bankruptcy court. Mr. Thibodeaux agreed to appraise the truck's fair market value. Mr. Thibodeaux then conducted a careful physical inspection of the truck. He started it and drove it. He examined its mechanical and body components. He examined the maintenance and DOT logs. Mr. Thibodeaux then interviewed Mr. Rash as to what his driving arrangements were including whom he drove for and under what terms. Mr. Thibodeaux deals in trucks daily. He knew the value of an equivalent vehicle new and the rate of depreciation. He knew the age of the truck. He knew that Mr. Rash did not have a certain income from Lane but that his haul revenues could wildly fluctuate. He therefore immediately rejected use of the replacement cost (new minus depreciation) method (the number would end up five to six thousand dollars too low) and the income method (no sum certain income stream on which to base the calculation) and therefore adopted the comparables method. Mr. Thibodeaux had a good idea from his experience alone what the truck could get in the market place. Mr. Barron had instructed Mr. Rash to ask Mr. Thibodeaux to include both a wholesale and a retail number because Mr. Barron did not know which the bankruptcy court might require or what the Associates might try to prove. But Mr. Thibodeaux explained to Mr. Rash that the retail number was suspect because accurate retail numbers were hard to come by and further inappropriate for an appraisal. But he agreed to include a retail market conclusion. He then did some research on truck values. Mr. Thibodeaux keeps on hand a number of magazines which show offerings by truck owners of trucks

to be sold or bought. From this information and his own experience Mr. Thibodeaux was able to come up with a fair market value, which he characterized as "wholesale". He arrived at the retail number by consulting the MacLean-Hunter Market Report Blue Book (not, as has been assumed by many, the N.A.D.A. Blue Book), a report which shows actual sales of similar trucks at retail truck dealers who are reporters to MacLean Hunter. He then, based on his experience, deducted twenty-five per cent from the MacLean Hunter number and compared the number to his wholesale number. They were within a few dollars and he rounded the result. Rounding is viewed by the *Uniform Standards of Professional Appraisal Practice* not as customary but as mandatory.

He then presented to Mr. Rash a written report. He subsequently was called upon to testify in the §502 hearing.

Mr. Rash did not want to reduce his proposed distribution to unsecured creditors but the Thibodeaux appraisal was some three thousand dollars higher than his initial plan amount. So Mr. Rash cut expenses from his budget, increased his plan payments to the Associates and filed his First Amended Plan. This plan also called for secured creditors to be paid 9% interest.

At the §502 hearing, the Associates called, as plaintiff, a loan officer with the company who had no experience appraising trucks and who had never seen the truck. He gave an opinion as to the "retail" value of the truck based on reading the "Blue Book". He admitted the Associates was rarely able to get retail value when they resold repossessed trucks. The Rashes then called Mr. Thibodeaux. He testified that the value of the truck was

$31,875.00. On cross-examination by the Associates, he refused to admit that retail value was the fair market value of the truck and stuck to the value he gave on direct.

The bankruptcy judge subsequently issued his finding of fact that the value of the truck was $31,875.00. In a later hearing, the judge confirmed the Rash First Amended Plan of Reorganization which had incorporated that value as the Associates allowed secured claim.

V. Mr. Rash's Performance Under the Plan

Thereafter, Mr. Rash missed no work. He actively maintained his truck. At the end of his plan, he was successful in preserving the life of his truck, now at 929,000 miles. And he was able to stay even with the plan and his family expenses and accumulate enough reserves to prepay his plan four months early. During the course of his chapter 13 plan, Mr. Rash never missed a payment. This for five long years, the maximum time a bankruptcy court may allow a chapter 13 plan.

According to the chapter 13 trustee accounting which closed out this chapter 13 reorganization, Mr. Rash was able to pay his secured debt of $51,931.22 in full. He paid the IRS in full $2,745.00.[1] He paid $5,771.49 on unsecured, non-priority debt of $22,351.39 (including the Associates' unsecured deficiency claim) for approximately a twenty-six per cent distribution to his unsecured creditors. He made all Associates secured payments, principal of $31,875.00 and

[1] Mr. Rash burned 103,400 gallons of diesel fuel during his reorganization, paying the United States $25,00 in federal fuel taxes and $20,680 in state fuel taxes. Additionally, he paid the United States $50,827 in income taxes during the five plan years. "Fresh start" for the United States should mean restoring a citizen to taxpaying status.

interest of $7,551.66 for a total of $39,426.66 and in addition was able to pay them another $2,400.38 on the unsecured portion of their claim. He even paid the chapter 13 trustee a fee of $4,306.97. It is hard to imagine a court requiring any more of a chapter 13 debtor.

Mr. Rash's truck is now at the end of his useful life and he needs to replace it. While it has little trade-in value, it does have some and every penny was put there by Mr. Rash's maintenance efforts.

The bankruptcy court's allowance of the lower amount to the Associates enabled the Rashes to make a significant distribution to their unsecured creditors. Had the higher amount been allowed, the monthly payment would have been $885.03 or $215.26 higher per month. There simply wasn't room in the Rash budget for that increased payment. The Rashes would not have been able to formulate and complete a Chapter 13 plan.

SUMMARY OF ARGUMENT

Creditors who file claims in bankruptcy are allowed their claims as filed unless some party objects to the claim. 11 U.S.C. §502.[2] The bankruptcy court adjudicates contested claims. 11 U.S.C. §502; F.R.B.P. 3001, 3002 and 3007.

This process is also as the method also of determining the value of a creditor's security interest. §506.

In our case today, two debtors have proposed to pay to a secured creditor, pursuant to a chapter 13 plan of

[2] Consistent with Petitioner's brief, all citations will be to 11 U.S.C. unless otherwise indicated.

reorganization, payments which they contend have, as of the date of the confirmation of the chapter 13 plan of reorganization, a present value, §1325 (a), equal to the value of the secured creditor's collateral, a heavy truck, 11 U.S.C. §506 (a). A bankruptcy court agreed, holding that the value of that truck was to be measured by the probable net proceeds to the secured creditor if the secured creditor had repossessed and sold its collateral. This is the proper standard.

The Petitioner, the secured creditor, contends that the bankruptcy court should have valued the truck based on the debtors' having hypothetically to go out into the market and purchase a replacement for the truck. The statute does not say that. The history of the statute does not support that theory. And our every day, real world experience at resolving disputes over values also does not support that theory.

To understand why the Petitioner's theory is wrong and the bankruptcy judge's standard was proper, Respondents would first thoroughly discuss the background of this case, then the wording of §506 (a), then the history of 11 U.S.C. §506 (a), and finally how property is valued day in and day out in American commerce.

ARGUMENT OF LAW - THE VALUATION ISSUE

I. The Wording of §506 (a)

§506 (a) states:

> (a) An allowed claim...is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property...Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such

> property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.

§506 (a).

The section can be applied in all five chapter proceedings under Title 11 and in many different contexts. The language Congress provides us can be a clear roadmap, some general guidance, or no help at all in a given context.

In a Subchapter of Title 11 entitled "Collection, Liquidation, and Distribution of the Estate, 11 U.S.C. §721 et seq., a chapter seven trustee is authorized to liquidate and distribute the estate to its creditors. The trustee abandons assets of the estate in which the estate has no equity, 11 U.S.C. §554, and sells assets for cash when the estate will realize some net proceeds, See F.R.B.P. 6004.

A trustee and a secured creditor can clash over whether an asset has equity. We know in such a proceeding that the proposed disposition is auction by the trustee. The valuation adjudication is an attempt to guess at the result of the auction.

A trustee or a debtor can sell an asset free and clear of liens and encumbrances, §363, with the lien attaching to the proceeds of the sale. If a trustee, for example, proposes to continue to operate the debtor's convenience store until the stock is sold, a secured creditor with a lien on that stock could insist that the stock be valued at retail, since that is how the trustee proposes to sell the collateral.

A railroad might have a great deal of value in operations, but its rolling stock and rights of way individually may have only scrap value. In a chapter 11 reorganization, its investment bankers would put a going

concern value on the railroad when the business is proposed to be sold as a going concern.

These examples presume there is a proposed disposition of the collateral.

In our case, the proposed disposition is "none". It takes quite a reading to find any specific guidance from §506 (a) as to a specific valuation standard when there is no proposed disposition. Refine the articulation of the proposed disposition or use. The truck, it was proposed, would be used to generate revenue by hauling freight. Perhaps, had Petitioner brought evidence on that proposed disposition or use, some light would have been shed on the truck's value. A truck doesn't have "going concern value" but a truck can generate revenue. Had Petitioner pursued this line, as will be developed later, the ability of the truck to generate revenue was speculative and considerably less than most would say reflected a fair value for the truck.

One more articulation of "proposed disposition or use". The debtor proposed to retain the truck as collateral to the secured creditor's claim. That is the clearest statement of the proposed use or disposition of the truck. And §506 (a) would then say that the truck should be valued as collateral, the probable net proceeds on repossession and sale of the collateral by the secured creditor.

What was the purpose behind the valuation? In the trustee's auction example, it is to guess at the outcome of a sale to determine who gets to conduct the sale, the trustee or the creditor. But our proceeding was called to determine how much money the debtor had to propose to pay to the secured creditor in the chapter 13 plan. How much money the debtor would pay to the secured creditor to equal the probable net proceeds to the secured creditor on repossession

and sale of the truck. In other words, what was the cash equivalent value of the truck, as is, where is?

§506 (a): "Such value shall be determined...in conjunction with any hearing on such disposition or use..." 11 U.S.C. §506 (a).

The secured creditor industry has managed to scare a number of courts and other parties with the unexpected windfall argument. The argument states that, on reducing a secured creditor's allowed secured claim, a debtor can then manipulate a windfall by selling the collateral, or at least experience a windfall if the vehicle is wrecked and insurance pays a larger amount. See Pet. Brief, p. 37, NationsBank Brief, footnote 13, p. 19, both citing *Winthrop Old Farms Nurseries, Inc., v. New Bedford Inst. for Sav.*, 50 F.3d 72, 76 (1st Cir. 1995).

But those urging that theory and the *Winthrop* Court overlook a simple procedural issue in §506 (a) quoted above. The §506 (a) valuation is done solely for determining the allowed secured claim's treatment in the reorganization. A sale of the vehicle requires a separate proceeding under §363 with a separate adjudication of the distribution of the proceeds of the sale. §363. The §1325 (a) value is not res judicata the §363 value. Similarly, when a car is wrecked, the casualty loss is a §363 sale and the distribution of insurance proceeds requires the permission of the bankruptcy court in a §363 adjudication. The bankruptcy court is not bound by the §1325 (a) value. In order for the debtor to have experienced the windfall described by NationsBank someone needed to have been asleep at the switch.

Petitioner contends that you should not hypothesize a repossession and liquidation sale when none is contemplated. But how else do you determine what a discrete piece of 5

tangible personal property is worth unless you hypothesize the sale of that property?[3] When you ask the question what is a truck worth, you are asking the question what can I get for the truck if I sell it.

That is what the secured creditor would do with the truck if the debtor opted to return the truck under 11 U.SC. §1325 (a) (5) (C). The secured creditor would not use the truck to generate revenue; this secured creditor would not put it on its retail lot to sell. It would liquidate the collateral; it would sell the truck for cash.

The United States, in its amicus brief, states:

> As the court explained in In re Taffi, 96 F.3d at 1192-1193, "[t]here is nothing inequitable" in valuing collateral retained by the debtor at its fair market price for, by "allowing the [debtors] to retain [the collateral,] the [creditor] runs a risk" that ultimate recovery will be deferred or defeated. When a creditor is permitted to sell property at foreclosure, the net proceeds are then promptly received. When by contrast, the "proposed disposition" is for the debtor to retain the property, the creditor receives payment of its secured claim only in small portions over time.

U.S. Brief, p. 15.

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[3] Respondent's counsel collaborated extensively with Professor David Carlson in the preparation of his article, "Car Wars: Valuation Standards in Chapter 13 Bankruptcy Cases," Carlson, David Gray, 13 *Bankruptcy Developments journal* 1. He agrees that all valuations involve some form of hypothesis, see Id., p. 18; Carlson, David Gray, "Secured Creditors and the Eely Character of Bankruptcy Valuations", 41 *American University Law Review* 63, 70.

What the United States forgets is the Rashes paid the Associates $7,551.66 to "run that risk".

Petitioner argues:

> "Debtors in Chapter 13 fail at extraordinary rates, with fewer than a third still making payments an average of two years after confirmation."
> quoting Teresa A. Sullivan, et al., *As We Forgive Our Debtors* 222 (1989).

Pet. Brief, p. 34.[4]

The United States says:

Studies have shown that the majority of chapter 13 plans fail. *See In re Rash*, 90 F.3d 1036, 1064 n.6 (5th Cir. 1996).

Brief of the United States, p. 26.

The Rashes' plan didn't fail. With the standard proposed by the Petitioner, it never would have gotten off the ground. Chapter 13's viability is clearly on the line in this case.

In its amicus brief, the Washington Legal Foundation argues that creditors' rights "should be impaired in bankruptcy only when necessary to maximize net asset distributions to the creditors as a group", quoting Thomas H. Jackson and Robert E. Scott, Symposium on the Law and Economics of Bargaining: On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain, 75

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[4] Some of these failures are in jurisdictions applying the retail standard at present.

Va.L.Rev. 155, 155-156 (1989), WLF Brief, footnote 13, p. 19. Is there any doubt that this is exactly what happened in this bankruptcy?

The United States has intervened as amicus in this case because of its involvement in the Taffi case, *In re Taffi*, 96F.3d 1190 (9th Cir. 1996). This case however is far more typical of the Internal Revenue Service's traditional role in bankruptcy. In most chapter 13 reorganizations, the Internal Revenue Service will be an unsecured creditor, competing with the secured creditor for the disposable income of the debtor.

This simple valuation standard is well supported in the case law over the years, the traditional history of bankruptcy, and the statutory history of the Bankruptcy Code. Amicus, National Association of Consumer Bankruptcy Attorneys, has done an excellent job of relating that history in her brief, and the Rashes commend the Court's attention to her brief.

The Rashes would direct the Court's attention to two specific areas. First, a view of the transition from Chapter XIII of the Bankruptcy Act to Chapter 13 of the Bankruptcy Code is especially useful to understanding §506 (a).

Second the Rashes' theory is strongly consistent with and supported by modern appraisal theory. On the one hand, courts tell appraisers how to appraise and not vice versa. On the other hand, appraisers will always appraise outside the court room with an eye toward honesty, accuracy and objectivity, and this Court should mandate fundamental alterations in appraisal methodology for only the most compelling reasons or clearest directives from Congress.

II. The Law Prior to the 1978 Bankruptcy Code

In order to understand how Congress intended of secured debt be treated in the 1978 Code, one needs to understand the changes that were made from the treatment of secured creditors under the Chandler Act, P.L. 696, 52 Stat. 840-940, June 22, 1938. In order to understand how the Chandler Act treated secured debt, one needs to understand the peculiar and unfortunate timing of the *Louisville Bank* and *Wright* cases.

Some background. Chapter 13 was actually born in the 1920's in the District of Alabama bankruptcy court. See Analysis of H. R. 12889, House Judiciary Committee print, 74th Congress, 2d Sess. at iv (1936); Hearings on H. R. 8046 before the House Judiciary Committee, 75th Congress, 1st Sess. ser. 9 at 102 (1937); Hearings on H. R. 8046 before the Senate Judiciary Committee, 75th Cong. 2d Sess. at 61-62 (1937); 81 Cong. Rec. 8646-8647 (1937). A referee there, Valentine Nesbit, noticed that a number of the individuals coming before him were not totally destitute but did have some ability and desire to make some payments on their debt. Referees were far more active in the administration of their cases under the 1898 statute. This referee began to organize debtors and creditors into committees with a goal of seeing how far some of the debtors might go in repaying their debt on an ongoing basis. All of his initial efforts were done on a totally consensual basis and he had great early success. The laudatory nature of his efforts reached Congress which, had in the early 1930's began to reexamine the 1898 Act to accommodate the tragedy of the Great Depression. 81 Cong. Rec. 8646-8647 (1937).

At this point in time an unfortunate timing in Supreme Court decisions then intervened. Congress had in its first attempts at bankruptcy reform directly addressed the question

of farm mortgages by the passage in 1934 of the Frazier-Lemke Act, June 18, 1934, c. 869, 48 Stat. 1289, 11 USCA §203 (s). The Frazier-Lemke Act added a subsection "s" to §75 of the 1898 Bankruptcy Act, March 3, 1933, c. 204, 47 Stat. 1470. That section created a system of agricultural compositions, a forerunner of our present Chapter 12, 11 U.S.C. §1201 et. seq. The subsection allowed a "bankrupt" who failed to obtain consents to a §75 composition to take one of two options.

1) The bankrupt could purchase the property at its appraised value, acquiring title and immediate possession, by agreeing to make deferred payments of 2½% within two years; another 2½% within three years; 5% within four years; another 5% within five years and the balance within six years. All deferred payments bore interest at 1%. 48 Stat. 1289, See *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555 (1935).

2) Or the bankrupt could stay the foreclosure on or repossession of the farm for a period of five years by paying into the bankruptcy court a reasonable rental annually. 48 Stat. 1289, *See Louisville Joint Stock Land Bank v. Radford, Ibid.*, at 857.

The subsection contained a key proviso: "...Provided, however, That the provisions of this Act [subsection] shall apply only to debts existing at the time this Act becomes effective [on June 28, 1934]. 48 Stat. 1289, *See Louisville Joint Stock Land Bank v. Radford, Ibid.*, at 857.

The Radfords mortgaged their Kentucky farm to the Louisville Joint Stock Land Bank, which subsequently attempted to foreclose on the farm. The Radfords filed a bankruptcy and arranged for the referee to sell them the farm at fair market value, all pursuant to the terms of the Frazier-

Lemke Act. The Bank appealed. In *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555 (1935), this Court held that the Frazier-Lemke Act was unconstitutional, Id. at 869. Justice Brandeis, in his opinion, emphasized that Congress' Article I authority to legislate regarding bankruptcies was virtually limitless, the sole condemning aspect of the Frazier-Lemke Act being its specific targeting of pre-existing mortgages. Id., at 581-583.

The impact of *Radford* was instantaneous and oversimplified. Congress immediately took Radford to stand for the proposition that it was not to meddle with secured debt in bankruptcy at all. *See for example* Hearings on H. R. 8046 before the Senate Judiciary Committee at 56, 61-62.

Debate on the Chandler Act followed. An early draft of Section 74 had permitted the extension of secured debts. In congressional hearings, Judge Charles Adams, a referee from the Northern District of Illinois and a participant in the legislative drafting process objected that those provisions would violate the Fifth Amendment and that the bankruptcy process of necessity needed to deal with secured creditors individually. Hearings on H. R. 8046 before the Senate Judiciary Committee, 75th Cong. 2d Sess., at 56. R. Preston Sealey, of the National Retail Credit Federation disagreed, arguing properly but unsuccessfully that Radford should only be applied to the extension of debts contracted to prior to the passage of a bankruptcy act. Hearings on H. R. 8046 before the Senate Judiciary Committee, 75th Conbg. 2d Sess., at 61-62. A subsequent draft which was to become Chapter XI was prepared by Reuben Hunt and Jacob Weinstein of the Commercial Law League and Watson Adair, chair of the National Association of Referees in Bankruptcy. In their report, they stated:

> The provision for the extension of secured debts is particularly unsound. Any interference with the free exercise by secured creditors of their remedies is bound ultimately to impair a liberal extension of credit.

Analysis of H.R. 12899, House Judiciary Committee print, 74th Congress, 2d Sess., p. 38 (1936).

The same National Bankruptcy Conference draft, in its report on Chapter XIII, went on to state:

> We have provided that the unsecured creditors be dealt with as a class, and that the acceptance of a plan by them be by a majority in number and amount of their claims; but in the case of the secured creditors, we have provided that each be dealt with individually...The provision for so dealing with secured creditors is made necessary by the decision of Louisville Joint Stock Land Bank v. Radford."

Analysis of H.R. 12899, House Judiciary Committee print, 74th Congress, 2d Sess., p. 38 (1936).

Earlier, on August 28, 1935, in response to the Radford decision, Congress passed a new Frazier-Lemke act, c. 792, 49 Stat. 943-945, 11 USCA §203 (s). The new act again dealt with pre-existing mortgages only and contained a number of significant impairments to the rights of the mortgage holder to enforce its mortgage. However, there was afforded a modicum of due process in the procedure. And the secured creditor was allowed to retain its lien. Brandeis again wrote for this Court which announced that the new Frazier-Lemke Act was now constitutional, *Wright v. Vinton Branch of Mountain Trust Bank of Roanoke*, 300 U.S. 440 (1937). The announcement appears to have been too late

to make any difference in the Chandler Act debate and drafts.

In its final version the Chandler Act Chapter XIII, §§601-686, left secured creditors virtually unaffected. P.L. 696, 52 Stat. 840-940, June 22, 1938. The treatment of secured debt under the Chandler Act reflects the chilling effect of the Radford decision. First, the Act excluded from the definition of "claims" all claims secured by estates in real property or chattels real, Article II, Definitions, §606 (1). Second, the act gave an absolute veto to secured creditors over confirmation of the plan of reorganization. Each secured creditor had to accept the plan before it would be confirmed. §652 (1).

Mature case law during the later Chandler Act period gave a secured creditor two options - to consent to its treatment or to file a petition for reclamation of the collateral, which would be granted. *See for example, In re O'Dell*, 198 F.Supp. 389 (D.Kans. 1961); *In re Copes*, 206 F.Supp. 369 (D.Kans. 1962); *but see In re Clevenger*, 282 F.2d 756 (7th Cir. 1960).

Congress then revisited the wage earner reorganization when it drafted the 1978 Bankruptcy Code. In its response to the Chandler Act Chapter XIII, in §§502, 506 (a), 1322 (b) (2), and 1325 (a) (5), Congress eliminated the right of a secured creditor to refuse to consent to the chapter 13 plan and in lieu of the right to reclamation gave the secured creditor the right to the cash equivalent of its collateral (including interest), §1325 (a) (5). All aspects of the secured debt contract were abrogated, the debt was novated to a new debt and to that novated debt Congress granted the debtor the ability to earn the defense of payment, §1325 (a) (5). For purposes of the statutory interpretation of Chapter 13, reference thereafter to the contract, the

contemplation of the parties in the transaction, the expectancy of the parties in the transaction, and the Fifth Amendment property rights of the secured creditor are inappropriate. Congress spelled out the entire bill of rights of the secured creditor in a chapter 13 in sections 1325 (a) (5), 506 (a) and 502.

It is the right of the secured creditor to reclaim and liquidate its collateral that the debtor must pay for. §1325 (a) specifically states with respect to non-consenting secured creditors that the debtor must either (1) obtain the secured creditor's treatment; (2) return the collateral to the creditor (the Chandler Act choices) or (3) pay the creditor's allowed secured claim. In the context of a chapter 13 reorganization, the net proceeds to the secured creditor on repossession and sale of its collateral--what it would have received if it would have foreclosed on the property--are what Congress intended to allow to the secured creditor. §506 (a).

For nearly twenty years now the system has adjudicated the §506 (a) value with little controversy. Certainly no one who ever consulted an automobile appraiser would encounter any valuation standard confusion.

III. Value and Appraisal

In addition to not being supported by the plain language of the statute, or the intent of the Congress in creating the Bankruptcy Code and Chapter 13 as a whole, there are two additional problems with the Petitioner's proposed standard that collateral be valued based on the retail cost the debtor would have to pay to replace the collateral. First the standard radically departs from traditional appraisal theory, appraisal as now federally regulated. *See BFP v. Resolution Trust Corp.*, 511 U.S. 531 (1994). Second, the standard rests on a segment of the market whose reported

values are universally recognized as unreliable.

Our courts have long dealt with the process of valuing property, See for example Texas Pattern Jury Charges PJC 203.01- "Present Value":

> The present value of an asset is its market value unless it has no market value.
>
> "Market value" is the price the asset will bring when it is offered for sale by one who desires to sell, but is not obliged to sell, and is bought by one who desires to buy, but is under no necessity of buying.

Texas Pattern Jury Charges 203.01, p. 203-3.

And appraisal of property has long been a recognized branch of the field of economics, See The Appraisal Institute, *The Appraisal of Real Estate*, (10th Edition, 1992), p. 18-22.

Recently, appraisal has become the subject of Federal regulation. 12 C.F.R. Part 34, Subpart C, §34.41 *et.seq.* The publication, *The Uniform Standards of Professional Appraisal Procedure*, recites an expanded definition of market value:

> A current economic definition agreed upon by agencies that regulate federal financial institutions in the United States of America is:
>
> The most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus.

Uniform Standards of Professional Appraisal Practice, The Appraisal Standards Board (1995 Edition), p. 7-8; *See* 12 C.F.R. §34.42(g).

USPAP95 also recites a definition of appraisal:

> APPRAISAL: (noun) the act or process of estimating value, an estimate of value.

Uniform Standards of Professional Appraisal Practice, The Appraisal Standards Board (1995 Edition), p. 7.

A. Appraisal of Personal Property

Appraisal is a recognized branch of economics. The Appraisal Institute has defined appraisal:

> Appraisal is defined as the act or process of estimating value.

The Appraisal Institute, *The Appraisal of Real Estate* (10 th Edition, 1992), p. 10.

While his treatise was a summary of the state of the discipline as it existed at the time of the initial publication of the treatise, it is generally accepted that the treatise by James Bonbright entitled *Valuation of Property* is the font of modern appraisal theory. Bonbright, J., *Valuation of Property* (Michie Co., 1937, reprinted 1965).

Bonbright is the first to break out the three currently recognized techniques for appraising property. *Ibid.*, at 53,54. His terminology was "sales" (now comparables), *Ibid.*, chapter VII, p. 127-149, replacement, *Ibid.*, chapters IX and X, p. 150-215, and income, *Ibid.*, chapter XI, p. 216-232.

The academic work has not stopped there. Two significant private academic bodies, the Appraisal Institute in Chicago and the Institute of Property Taxation in Washington, D. C., both publish periodically treatises which update appraisal theory as it develops. See The Appraisal Institute, *The Appraisal of Real Estate* (10th Edition, 1992). The American Society of Appraisers publishes the periodical *Valuation*, containing monographs in different appraisal topics. Texas A&M University maintains an Appraisal Institute on its College Station, Texas, campus.

Appraisal is not just an academic discipline. Because the concept of value is so fundamental to the American economy, appraisal is a significantly regulated activity.

Earlier, in 1978, Congress established the Financial Institutions Examination Council to prescribe uniform principles and standards for the Federal examination of financial institutions. 12 U.S.C. §3301 et seq. This statute created the Appraisal Foundation as the source of appraisal standards and qualifications. 12 U.S.C. §3333 (b).

It was the specific belief of Congress that the savings and loan disaster in the United States was attributable in part to a failure on the part of the financial, judicial and regulatory communities to properly define, regulate and police the appraisal activity. So, in 1989, as a part of the Financial Institutions Reform, Recovery and Enforcement Act of 1989, Congress created the Appraisal Subcommittee of the Council generally to monitor appraisal standards in the States, 12 U.S.C. §3333 (a), but specifically to monitor and review the practices, procedures, activities and organizational structure of the Appraisal Foundation. 12 U.S.C. §3333 (b). The Appraisal Foundation had established an ad hoc committee to promulgate the *Uniform Standards of Professional Appraisal Practice* in 1986. In 1989, as a result

of the FIRREA amendments, it formed the Appraisal Standards Board to formally monitor and revise these standards over time. In 1989 the Board formally adopted the Foundation's *Uniform Standards of Professional Appraisal Practice* and has since that time revised and republished them from time to time, the last edition being the 1995 edition.

Congress contemplated a joint federal/state effort. In order to perform an appraisal for a federally insured institution, the appraiser must have a state appraisal license. 12 U.S.C. 3333. Few states had an appraisal licensing scheme however. So virtually all states then created licensing boards so their appraisers could qualify to perform appraisals for federally insured institutions. *See* Vernon's Ann.Civ.Stat. art. 6573a.2 (the "Texas Appraisal Licensing and Certification Act"). The states then generally picked up USPAP as the official source of canons of ethics and statements of procedures for those desiring to obtain and maintain an appraisal license. So, for example, the most recent edition of the *Uniform Standards of Professional Appraisal Practice*, 1995, has been adopted by the Texas Board of Appraisal Licensing and therefore constitutes State as well as Federal regulation.

It is a mistake to assume that the regulatory effort has been aimed at real estate appraisal. Two of the ten standards, Standard No. 7 and Standard No. 8, are specifically directed to the appraisal of personal property. *Uniform Standards of Professional Appraisal Practice*, The Appraisal Standards Board (1995 Edition), p. 43-49.

The Preamble to the Uniform Standards clearly states the Standards "...contain binding requirements..."., *Uniform Standards of Professional Appraisal Practice*, The Appraisal Standards Board (1995 Edition), p. 1.

Appraisal theory is applicable to the valuation of all types of property, whether real or personal, tangible or intangible. Bonbright, J., *Valuation of Property*, op. cit., at 13, 53-54 (Michie Co., 1937, reprinted 1965). The principles and methodology are identical, regardless of the type of property being appraised, while obviously some issues may be more important than others in context. Ibid, at 13, 53-54. USPAP95 Standards Rule 7-3 (e) mandates the appraiser use the cost, income and sales comparison approaches in appraising tangible personal property. *Uniform Standards of Professional Appraisal Practice*, The Appraisal Standards Board (1995 Edition), p. 44-45. A great deal of Bonbright's treatise is devoted to the valuation of railroad rolling stock, an important issue in the early 1930's. Bonbright, J., *Valuation of Property*, *op. cit.*, at 150-215 (Michie Co., 1937, reprinted 1965).

The Appraisal Institute has defined the three traditional approaches:

> In assignments to estimate market value, the ultimate goal of the valuation process is a well-supported value conclusion that reflects all the factors that influence the market value of the property being appraised. To achieve this goal, an appraiser studies a property from three different viewpoints, which correspond to the three traditional approaches to value.
>
> 1. The current cost of reproducing or replacing the improvements, minus the loss in value from depreciation, plus site value--the cost approach.
>
> 2. The value indicated by recent sales of comparable properties in the market--the sales comparison approach

3. The value of a property's earning power based on the capitalization of its income--the income capitalization approach.

The Appraisal Institute, *The Appraisal of Real Estate* (10th Edition, 1992), p. 71.

The income capitalization approach locates an income stream generated by the property, quantifies that stream and discounts that stream to present value. The theory inherently holds that the value of the property is determined solely by the income it generates. See The Appraisal Institute, *The Appraisal of Real Estate* (10 th Edition, 1992), chapters 18-22, pp. 408-551. It is appropriate in those cases where the property generates significant, stable income over extended periods of time, usually the useful life of the property being valued, and other properties are only marginally comparable. It is inappropriate if no stable income stream can be quantified. See David P. Doan and Richard A. Southern, "Economic Life in Appraising Leased Equipment: Role of Market Value and Capitalization of Income," *ASA Valuation*, (January 1990), p. 82.

Income generating real estate, apartments, hotels, office buildings, are more often than not appraised using the income method. *See* The Appraisal Institute, *The Appraisal of Real Estate* (10 th Edition, 1992), chapter 18, pp. 408-427.

The cost, or replacement cost, approach takes the cost of purchasing a new, similar item and then subtracts from that sum depreciation on the property being valued. The Appraisal Institute, *The Appraisal of Real Estate* (10 th Edition, 1992), p. 80. It is appropriate where precise determination of new cost can be determined, the property is likely to generate income but has not yet done so,

comparables cannot be located, and depreciation is more often than not negligible. The Appraisal Institute, *The Appraisal of Real Estate* (10 th Edition, 1992), chapters 14, 15 and 16, pp. 312-365.

For example a newly constructed factory would be appraised at replacement cost. Inventory is more often than not appraised at replacement cost.

Properly, contrary to the argument of the Associates, the replacement cost approach does not seek values for substituted equivalents. *See* Pet. Brief, p. 22. The Fifth Circuit panel opinion in this case made that same semantic and terminology mistake. They coined the phrase "replacement value". *In re Rash*, 31 F.3d 325, 326 (5th Cir. 1995). The Associates goes on to say that "replacement value" is the cost the debtor would incur to replace the collateral. Pet. Brief, p. 22. See also U.S. Brief, pp. 11-13. That definition can't be found anywhere in the literature. Interestingly enough, the Associates claims one should not hypothesize a foreclosure when none is contemplated. Pet. Brief, p. 13. It then hypothesizes a retail purchase when none is contemplated. Pet. Brief, p. 22. In fact, the Associates was advocating the use of the comparables method then seeking a mandate to use of the retail market as the pool of comparables, their "relevant 'market'", Pet. Brief, p. 22. It is axiomatic in the true replacement cost method that in the real world the owner would not seek out an exact substitute but would instead purchase the newest available and that an allowance must be made for the distinction between new and the item being valued. C.H. Donias, "Appraisal of Major Mechanics and Equipment," *ASA Valuation* (November 1951), p. 84. For example, the Appraisal Institute defines replacement cost as follows:

> Replacement cost is the estimated cost to construct, at current prices as of the effective appraisal date, a building with utility equivalent to the building being appraised, using modern materials and current standards, design and layout.

The Appraisal Institute, *The Appraisal of Real Estate* (10 th Edition, 1992), p. 319.

The allowance utilized to adjust the value is depreciation. *See* Appraisal Institute, The Appraisal Institute, *The Appraisal of Real Estate* (10 th Edition, 1992), p. 320.

The comparables method looks at the market place and determines whether equivalent properties are being routinely bought and sold and whether a price for those sales can be determined. It is appropriate if there is a ready market for the property in the vicinity of the property being valued and the property is not generating a significant, stable income unique to that property and not to the property in the market in general. It is inappropriate if the property being valued has for whatever the reason an ability to generate income over and above what similar property is then generating. *See* The Appraisal Institute, *The Appraisal of Real Estate* (10 th Edition, 1992), chapter 17, pp. 366-407.

Virtually all residential real property, all securities traded on national and large regional public markets, and most interchangeable manufacturing equipment are valued using the comparables method.

In using the comparables methodology, the appraiser is charged with selecting the appropriate market. Here, a distinction can be made between the appraisal as an adjudication and the appraisal as a predictor. So for

example, if a bankruptcy trustee proposes to auction collateral, and the secured creditor objects, claiming the auction will not produce a distribution above and beyond the lien to the unsecured creditors, one would expect that the appraisers employed by the parties choose those comparable sales produced by auctions, a process generally referred to as auction appraisal. *See* , Miles, Leslie and Bealmear, Allen, "Auction Value, Machinery and Equipment Appraisals" *ASA Valuation*, vol. 24, Number One, p. 42 (December 1977). Similarly, an automobile dealer might take a bankruptcy and as a part of its §1129 (a) (7) liquidation analysis produce a valuation of its inventory. The appraiser there may well choose the retail market as the most appropriate range of comparables. The choice of the market is a choice of which comparables are truly comparable.

The Rash's appraiser did use the comparables method. He referred extensively to reported sales of the truck on the open market and did not discount those reported values. The wholesale market is not totally populated by lenders selling collateral at foreclosure, *See* Pet. Brief, p. 22.

Other appraisal methods can be used. If for example, the property to be sold carried with it a significant income stream, a party bidding at the auction would be aware and price its bid accordingly and so even if an auction is proposed, the income method may still be the appropriate methodology.

The decision as to the appropriate method is one of the key elements in forming the value opinion. USPAP95 Standards Rule 7-3 states the appraiser must:

> (e) consider the cost, income, and sales comparison approaches and their degree of applicability in the valuation of personal

property. The selection of valuation approaches to be used should be based on the availability of data and the purpose of the appraisal;

Uniform Standards of Professional Appraisal Practice, The Appraisal Standards Board (1995 Edition), p. 45.

The process of selecting the proper methodology is referred to as reconciliation, and it involves three factors, the appropriateness of the methodology, the accuracy of the methodology and the quantity of evidence available to the methodology. The Appraisal Institute, *The Appraisal of Real Estate* (10 th Edition, 1992), pp. 555-558. The Appraisal Institute goes on to state:

> The final value estimate is not derived simply by applying technical and quantitative procedures; rather, it involves the exercise of judgment.

The Appraisal Institute, *The Appraisal of Real Estate* (10 th Edition, 1992), p. 558.

There is very little dispute among appraisers about how to appraise a truck. All the previously discussed principles of appraisal directly apply. First, all appraisals start with an extensive physical examination of the vehicle in question. *See Uniform Standards of Professional Appraisal Practice*, The Appraisal Standards Board (1995 Edition), Standards Rule 7-3 (f), p. 45. The specific items to be examined are outlined in the proposed valuation form published by *The Truck Blue Book*, a private publication of Maclean Hunter Market Reports, Inc., and the reference used by The Rashes' appraiser. *The Truck Blue Book*, Maclean Hunter Market Reports, Inc., p vii. The Rashes' appraiser followed this form.

For comparables information the appraiser may then refer to the published lists but it is clear that the published list should only be a reference point and should not be the exclusive reference point. *The Truck Blue Book* is regarded as the more authoritative of the "Blue Books", the other being the National Automobile Dealers Association *Heavy Truck Blue Book*. Five or six trade magazines, including, for example, *Truck Market News*, a Dallas, Texas publication of Specialty Marketing Corporation, publish both national and regional truck prices on monthly or quarterly bases. The Rashes' appraiser consulted all of those available publications.

In all cases, no appraiser ever relies on any of these publications. For one thing, these publications are quite inconsistent in their reporting. NationsBank, in a footnote, states that the NADA guide reports wholesale and retail values. NationsBank Brief, footnote 9, p. 15. The Eastern edition does. This publication was used by the Valenti court, *In re Valenti*, No. 95-5079, 1997, U.S.App. LEXIS 647, *10 (2nd Cir. January 15, 1997). And apparently the Irvine, California *Kelly's Blue Book*, an NADA publication does also. But the Southwestern edition, covering Arkansas, Louisiana, Oklahoma and Texas, uses retail and loan values and specifically refers appraisers to the national *NADA Wholesale Guide*, which reports national wholesale values only. NADA publications are private, none are truly "official", all change with time, and all are prepared by the retail auto industry, a classic example of the fox guarding the henhouse.

A physical inspection, constant contact with the market, constant review of a number of periodicals and market reports, extensive experience, and a specific knowledge of the purpose of the appraisal, the proposed use of the vehicle and the interest being appraised are all

essential components of a proper, ethical appraisal.

Had, as the Associates suggests this Court should hold, the bankruptcy court insisted on the use of the "replacement method", the replacement cost value of the Kenworth, properly calculated by depreciating a 1992 Kenworth, would have been $29,480, a sum significantly lower than the value used by the Rashes.

The Associates seems to want to argue that Mr. Rash's truck has "going concern value". Again this is a mishandling of basic terminology. An ongoing business can be valued as an entity ("going concern value") or its individual assets can be broken out and valued individually ("liquidation value"), *See* The Appraisal Institute, *The Appraisal of Real Estate* (10 th Edition, 1992), p. 23-24.

The Associates was really suggesting the employment of the income methodology to appraise the truck. Respondent has already suggested that when an income stream is unstable that methodology is inappropriate, but we have a golden opportunity here to reconstruct an income appraisal retrospectively since we know for sure all income this truck did derive during the course of the repayment.

The Associates attempts to apply income methodology to the appraisal of the truck but leaves out a key cost component. Mr. Rash was not just leasing his truck to Lane and Lane was not just paying lease payments for his truck. Mr. Rash was leasing an operated truck to Lane and Lane was paying for the truck to haul goods and the driver to drive the truck.

Now we know that Mr. Rash was the designated driver. An economist or "going business" appraiser, in applying the income method to the proposed revenue stream

($3,725.00 per month or average about $900 per week) would first calculate total revenues and then deduct from those revenues two expense categories, first the expenses of maintaining the truck ($400 per month or roughly $100 per week) and then a reasonable payroll cost for the driver.

There is ample evidence of reasonable payroll cost. The National Master Freight Agreement between national freight haulers and the International Brotherhood of Teamsters calls for a wage of $17.00 per hour or $.42 per mile. Using the per hour wage as a cost factor causes the truck to have a negative "going concern value". The calculation gets no better when you use the mileage value. Mr. Rash drove about 549,000 miles during the fifty-eight months of his plan or approximately 2,400 per week. Again the truck has a negative "going concern value". In fact, if you reverse the procedure and calculate the wage Mr. Rash would have earned per hour assuming that he was required to pay to petitioner the amount they claim is the "going concern value" of the truck, you would come up with approximately $6.20 per hour. That is not a reasonable wage component in the calculation.

The Associates argues that the proposed use of the property is important, citing §506 (a). The proposed use of the property can be important in some §506 (a) adjudications. USPAP95 Standards Rule 7-2 states:

> In developing a personal property appraisal, an appraiser must consider the purpose and intended use of the appraisal and observe the following specific appraisal guidelines:
>
> (a) adequately identify the property to be valued including the method of identification;

(b) define the purpose and intended use of the appraisal including all general and specific limiting conditions;...

(d) select and define the value to be considered consistent with the purpose of the appraisal;

(e) collect, verify, analyze and reconcile such data as are available, adequately identified and described, to indicate a value conclusion;...

Uniform Standards of Professional Appraisal Practice, The Appraisal Standards Board (1995 Edition), p. 44.

Property use is an extremely active topic in real estate appraisal but all property is affected by the concept. In analyzing use, the appraiser can look either to the actual use at the time of the appraisal or to a theoretical use being proposed.

In discussing the concept of use value, the Appraisal Institute states:

> Court decisions and specific statutes may also create the need for use value appraisals. For instance, many states require agricultural use appraisals of farmland for property tax purposes rather than value estimates based on highest and best use.

The Appraisal Institute, *The Appraisal of Real Estate* (10 th Edition, 1992), p. 22.

From this concept arises the principle of highest and best use. The best perspective to study this concept is real estate. A farmer is farming a tract. That tract has a certain value as farmland. It is located near a metropolitan area. In

fact the land may have a much greater value as development property.

The Appraisal Institute has developed a definition of highest and best use:

> Highest and best use may be defined as:
> the reasonably probable and legal use of vacant land or improved property, which is physically possible, appropriately supported, financially feasible, and that results in the highest value.

The Appraisal Institute, The Appraisal of Real Estate (10 th Edition, 1992), p. 45.

Congress did take a legislative position on the issue in §506 (a). 506 (a). All property is to be valued at the proposed use. 11 U.S.C. §506 (a). So again, in a chapter 12, if the farmer is proposing to farm a tract, it is appraised as farm land, even though it may have a higher development value.

But use isn't an issue in this case. The truck was proposed to be used to haul over the highway freight. The Rashes' and the Associates experts both knew that was the proposed use. That is how the vehicle was to be valued. That is how Steven Thibodeaux appraised it.

B. The Retail Market - an Unrealiable Source of Market Information

In connection with vehicles generally including trucks, this Court should be aware that the use of retail value is virtually never used by appraisers to any major degree must less given dispositive weight. The reason for that first lies in the definitions NADA gives to the two lists as it collects

the data. The retail list is compiled only using those NADA members who choose to report. It is compiled solely for the interest of its members as to how much they might try to mark up a vehicle to obtain a price in excess of its base worth. The wholesale list is the report of appraisers and voluntary auctions conducted throughout the country. Voluntary auctions always have been and always will be the most reliable source of willing buyer, willing seller information since they literally are calling together willing buyers and willing sellers with no predetermination as to price to be paid. NADA actually advises appraisers to use its national wholesale publication and not its regional retail publication.

The second reason is that the retail value does not reflect the vehicle being valued. It is actually the vehicle with enhancements of tremendous variation such as oil and filter changes, clean ups, in-house financing and warranties, repairs, the float associated with the length of time to sale and other items which do not show up in any itemization in the retail list but which nonetheless do significantly affect the net price obtained on sale. The Fifth Circuit *en banc* strongly emphasized this point, Pet. p. 30a-32a. The Associates concedes these facts in its brief. Pet. Brief, p. 23. Even "as-is" vehicles are enhanced in value in that their sale is generally covered by state "lemon" laws, *See* Vernon's Ann.Civ.Stat. art. 4413 (36).

In-house financing is an exceptionally significant issue. The Federal definition of market value requires that the transaction be a cash transaction, 12 C.F.R. §34.42 (g)(4). Amicus Chase Manhattan Bank, in its brief, admits that the bulk of its automobile loan portfolio is generated at the used care lot level. NationsBank Brief, p. 3. There has been an opportunity to scrutinize this industry recently. In the autumn of 1996, Mercury Finance, one of the nation's

largest purchasers of automobile paper in the secondary market filed a two billion dollar bankruptcy, largely related to growing litigation over the question of hidden finance charges and usury. This phenomenon was reported in the *Wall Street Journal* on February 5, 1997, under the heading "A Lemon of a Deal: Used-Car Lender Leaves a Sour Taste" by Jeff Bailey and Thomas Burton.

The article points out that, although an individual might pay fifteen to seventeen per cent interest to purchase a used car at a used care lot, the presence of in-house financing enables that lot to double and even triple the purchase price of the vehicle. That increased principal is literally hidden "points". Bailey, Jeff and Burton, Thomas, "A Lemon of a Deal: Used-Car Lender Leaves a Sour Taste," *Wall Street Journal*, February 5, 1997, p. 1.

These abuses are well known and cause few appraisers to seriously rely on reported retail sales.

C. The Breadth of §506 (a).

The Associates,, its amicus, and a number of courts writing on the topic seem to automatically assume that replacement value will always be higher than wholesale value. For example, the Fifth Circuit panel majority based its holding on a hypothesis that replacement value will always be higher than wholesale value. Matter of Rash, 63 F.3d 685, 692 (5th Cir. 1995). To the extent that the Court mandates replacement rather than real world values, it cultivates the potential for some gruesome outcomes.

1. Replacement value can be less than wholesale value. In a significant number of industries, for example computers, computer parts, and all other high technology, replacement value is generally less than wholesale value. Debtors in

those industries can reap windfalls. IBM leased on a three-year guaranteed lease basis to Gulf States Utilities a mid-frame computer. The lease payments created a net present value for the system of approximately $100,000.00. As is traditionally the case with computers, all of the computing power represented by IBM's machines could be replaced today in the retail computer market for approximately $15,000 to $20,000. Can a debtor in IBM's circumstances argue it should retain the lease and pay the secured creditor, whose collateral is the computer, only the $15,000 to $20,000 represented by "retail value"?

2. Replacement value can be measurably larger than wholesale value. Income generating real estate, apartments, office buildings, resorts, hotels, etc., rarely appraise at replacement value because that value is skewed unrealistically high. But high values, while they arguably benefit undersecured creditors, are a threat to over-secured creditors. Secured creditors holding first mortgages on those income-generating real estate properties commonly are oversecured. They can't get the advantage of the extra security in pay back because they are limited to their notes. The equity cushion prevents them from lifting the stay or receiving adequate protection payments. They are exposed to §364 superpriority, super lien loans. And in both chapter 11 and chapter 12 they are subjected to collateral dilution through lien stripping. Remember, the great savings and loan crash of the 1980's, the Resolution Trust Corporation, and the mandatory licensing of appraisers all grew out of overly optimistic, not overly pessimistic, appraisals. Chapter 7 trustees can seize and sell more collateral because arguably there is now estate equity in the collateral. And marginally secured creditors in chapter 11 proceedings will lose the tactical advantage of the §1111 (b) election.

c. In either case the trial of real estate values will be gutted. The three-method appraisal and its reconciliation, the key piece of testimony in the trial of real estate values, would be superfluous and even prohibited. Similarly there would appear to be no room for true business entity valuation since those valuations are strictly income method capitalizations, rather than replacement value calculations.

SUMMARY AND PROPOSED HOLDING

By way of summary, the Rashes would propose the following holding in disposition of this case:

The finding by the bankruptcy court that The Rashes' 1989 Kenworth truck had a value of $31,875.00 was not clearly erroneous. The judgment and order of the bankruptcy court is affirmed.[5]

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[5] All parties agree that the basic rights of a secured creditor unless otherwise dealt with by Title 11 are to be determined by reference to state law, See Pet. Brief, p. 25 citing *Nobleman v. American Sav. Bank*, 508 U.S. 324, 329 (1993). The basic right of the secured creditor is to be "paid in full" [emphasis sic], Pet. Brief p. 25. In fact, under Texas law, a lien on a motor vehicle is governed by the general law of mortgages, Vernon's Ann.Civ.Stat. art. 6687-1, §§3, 5,6. In Texas, a mortgage is extinguished when paid and has no independent existence from the underlying debt. *O'Dell v. First Nat. Bank of Kerrville*, 855 S.W.2d 410 (Tex. 1993); *Texas Bank & Tr. Co. of Dallas v. Custom Leasing*, Inc. 402 S.W.2d 926, 930 (Tex.app. Amarillo 1966); *Southland Life Ins. Co. v. Barrett*, 172 S.W.2d 997, 1001 (Tex.App.Ft.Worth 1943); *American Type Founder Co. v. First Nat. of Teague*, 156 S.W. 300, 301 (Tex.App. Austin 1913). Petitioner confirms this in its brief, Pet. Brief, p. 25-28. The bankruptcy court order affirmed by the Fifth Circuit *en banc*, clearly established the sum of money required to pay the debt in full, $39,426.66, Jt. App. p. 98. This is now the total debt, as the bankruptcy court clearly had the authority to novate that debt. Petitioner appealed that order but unsuccessfully and the Fifth Circuit issued its mandate enforcing that order. That mandate has never been stayed and the

Respectfully submitted,
MEHAFFY & WEBER
Attorneys for Respondents
ELRAY RASH AND JEAN RASH

By______________________
John J. Durkay, Of Counsel
State Bar No. 06285600

Post Office Box 16
Beaumont, Texas 77704
Telephone: 409/835-5011
Telecopier: 409/835-5729

bankruptcy court order has never been stayed. On compliance with that order and the making of the 58th payment called for by the order and their plan, the Rashes paid in full the debt. Under Texas law at that point in time with no further action required by the Rashes the lien was extinguished. If this case is remanded to the bankruptcy court, the Rashes intend to make that argument at that time and note the argument here to preserve it.